Directorate of Intelligence

The Chinese Economy in 1988 and 1989: Reforms on Hold, Economic Problems Mount

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August 1989

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This paper was prepared by the Central Intelligence Agency for submission to the Subcommittee on Technology and National Security of the Joint Economic Committee, Congress of the United States.

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The Chinese Economy in 1988 and 1989: Reforms on Hold, Economic Problems Mount

Preface

Information available as of 1 August 1989 was used in this report.

China's leaders experienced the greatest challenge to the authority of the Communist Party in 40 years of rule when massive demonstrations swept China this spring. The protests were symptomatic of public dissatisfaction with the leadership because of its unwillingness to make the political system more responsive to public concerns and inability to control growing official corruption, nepotism, and inflation—which approached 30 percent in China's cities last year, the highest level since the Communists came to power.

The demonstrations sparked leadership maneuvering that toppled Zhao Ziyang, one of China's most ardent market-oriented reformers, from the party's top post. An expanded meeting of the Communist Party Central Committee in June elevated leaders who believe greater political, ideological, and social control is necessary and who generally advocate economic reform strategies that emphasize improved central planning rather than experiments with market measures.

The unrest has weakened Beijing's ability to solve the country's economic problems. The preoccupation of China's leaders with consolidating power, restoring ideological orthodoxy, and maintaining social order will probably prevent them from formulating new solutions to the country's economic problems. Consequently, China's reform program is likely to be bogged down for the next few years. Indeed, key market reforms like price decontrol and bankruptcy—which Beijing put on hold in the fall of 1988 when it began implementing an austerity program—will be postponed indefinitely.

Inflation is likely to remain a problem. With economic reforms on hold, industrial efficiency and labor productivity will lag, and Beijing will have difficulty stimulating production of grain and industrial raw materials, items chronically in short supply. At the same time, pressures to increase government expenditures will probably grow in the aftermath of the demonstrations, fueling inflation. Beijing may attempt to increase food subsidies and loans to state enterprises to minimize the impact of rising prices on its restive urban labor force. To head off growing unhappiness among peasants—who are being pressed to grow more grain but are having increasing difficulty obtaining inputs and are being paid in IOUs—China's central bank may have to loosen credit restraints in the countryside. Defense expenditures also may rise because military leaders are exerting

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greater influence in Beijing following their suppression of the demonstrations. Persistent inflation will fuel social unrest by eroding standards of living, but rigorous enforcement of the austerity policies would probably swell the ranks of unemployed, embitter workers whose income subsidies do not keep pace with price rises, and anger farmers paid with IOUs for their crops.

Finally, Beijing's ability to draw on foreign resources to alleviate domestic shortages, promote exports, and fund infrastructure and industrial projects has been diminished by the reluctance of foreign businessmen and governments to sign new investment and loan agreements. Although China can probably weather the expected decline in tourism revenues and slower export growth this year, the downturn in China's international economic relations may dim China's long-term economic prospects. For example, industrial and export growth would probably slow if—to forestall a steep decline in its foreign exchange reserves—Beijing broadens its restrictions on imports to include capital equipment and raw materials. Moreover, if foreign businessmen choose alternative Asian sites for new technology-intensive investment projects, China will have greater difficulty competing with Asian exporters like Thailand, Malaysia, and the Philippines in the 1990s.

Contents

Student Protests: 15 April–3 June 1989

15 April	*Hu Yaobang dies.*
17 April	*First student demonstration in Tiananmen Square.*
20 April	*Demonstrations spread to Nanjing, Shanghai, and Chengdu; Beijing students declare a three-day strike.*
22 April	*Hu Yaobang's official memorial service is held. Demonstrations occur in Tiananmen, Shanghai, Chengdu, Guangzhou, Xian, and Harbin.*
23 April	*General Secretary Zhao Ziyang leaves for North Korea.*
24 April	*Students in Beijing form a citywide coordinating committee and declare a class boycott.*
26 April	Renmin Ribao *editorial criticizes the students.*
27 April	*150,000 students and activists protest in Tiananmen in one of the largest demonstrations to date.*
29 April	*Party officials hold a televised dialogue with representatives of officially recognized student groups, later disclaimed by student leaders on Tiananmen.*
30 April	*Zhao Ziyang returns from North Korea.*
2 May	*Students threaten to march in two days if the government refuses to begin negotiations.*
4 May	*An estimated 50,000 students are joined by 250,000 other citizens in a march to protest the government's refusal to negotiate. Zhao Ziyang delivers a conciliatory speech at a conference of representatives of the Asian Development Bank.*
13 May	*An estimated 1,000 students begin a hunger strike in Tiananmen.*
16 May	*Gorbachev arrives in Beijing. Crowds in Tiananmen swell to over 1 million.*
18 May	*Li Peng participates in a televised discussion with student leaders; Gorbachev leaves China.*
20 May	*Martial law is declared in Beijing. Troops surround the city but remain behind barricades set up by protesters. Li Peng states that Tiananmen will be cleared in two days, by force if necessary.*
23 May	*Troops remain behind barricades; 1 million march in Beijing to demand Li Peng's resignation.*
30 May	*"Goddess of Democracy" is unveiled in Tiananmen.*
3 June	*Troops begin to shoot demonstrators as part of the crackdown in Beijing.*

The Chinese Economy in 1988 and 1989: Reforms on Hold, Economic Problems Mount

Problems of an Overheated Economy

China's economic problems continued to mount in 1988 as the leadership failed to check overly rapid growth, soaring inflation, increasing official corruption, and a deteriorating trade balance. According to Chinese statistics, GNP grew by more than 11 percent in real terms and industrial output surged 21 percent, nearly three times the target rate. This intensified China's chronic energy and raw materials shortages and transportation bottlenecks and, in turn, pushed inflation to its highest level in nearly 40 years, 19 percent overall and almost 30 percent in China's cities. (See appendix A for a detailed review by sector of economic performance in 1988.)

The overheating occurred partly because Beijing relaxed credit controls in early 1988, apparently to "prime the pump" for industrial and export growth (see figure 1). China's currency in circulation increased 47 percent last year, adding to demand pressures that had been building since 1984, when Beijing sharply expanded the autonomy that industrial enterprises could exercise over investment, wages, and spending for their workers' social welfare. Urban enterprises financed these expenditures from retained earnings and by borrowing from China's central bank and from a growing number of nonbank financial institutions. In rural areas, local governments and informal credit cooperatives funded a dramatic expansion in rural industries and such commercial activities as marketing and transportation.

Inflationary pressures were intensified because of lagging agricultural production. The value of overall farm output inched up only 3 percent. Grain production actually fell 2 percent because of adverse weather, low state-set procurement prices, and rising costs of agricultural inputs like fertilizer and plastic sheeting, which is used as mulch. Sluggish production of industrial crops like sugar, ramie, and cotton caused production costs to rise in food processing and textile industries.

The acute shortages of raw materials gave rise to increased speculation and profiteering by local officials who acquired scarce goods at low in-plan prices and resold them on the market. Profits from such activities can be substantial; market prices for steel, fertilizer, and grain are two to three times the in-plan price. The increase in profiteering diverted industrial materials earmarked for use by state-owned enterprises to the collective and private sectors, where enterprises were willing to pay higher prices. In rural areas, officials frequently charged peasants high market prices for fertilizer and other scarce agricultural inputs that Beijing had promised to make available at low, state-set rates. Consequently, peasants reduced applications of fertilizer on fields, which hurt yields.

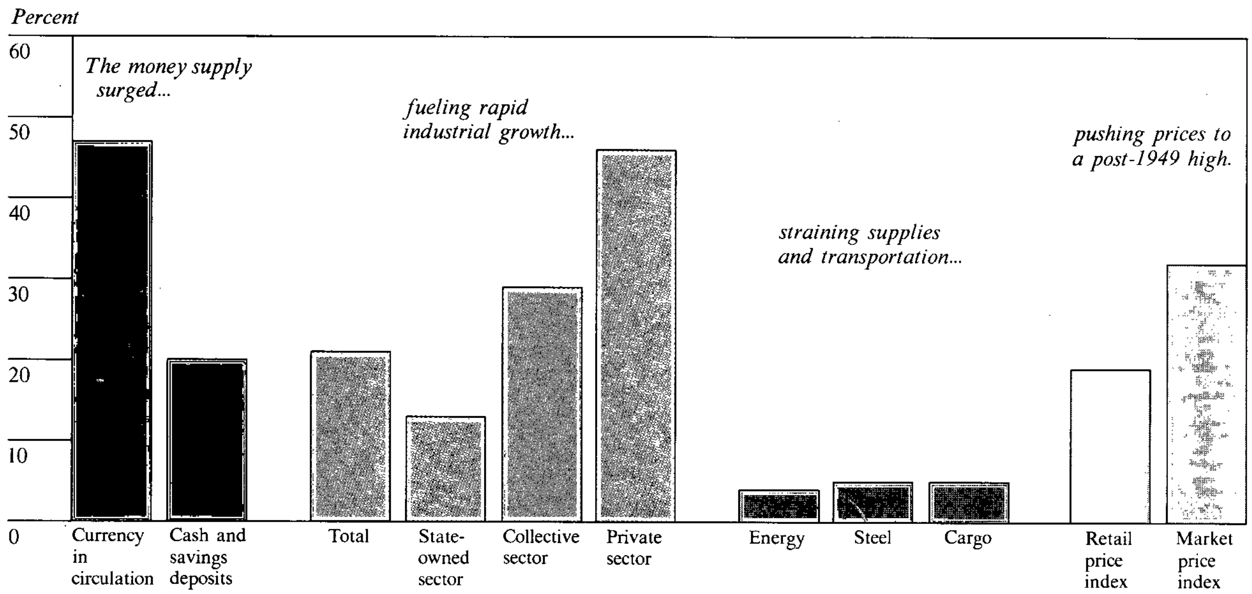
Inflation also caused income disparities to widen. Rural entrepreneurs and urban street vendors were able to cash in on surging demand for goods because they sell their merchandise at market prices. Wages of teachers and government bureaucrats are generally fixed, however, so their incomes failed to keep up with inflation. Overall, real urban incomes rose only 1 percent, according to Chinese statistics.

Trade Balance Worsens

Imports surged in the second half of 1988 as China turned to foreign suppliers for many of the industrial and agricultural products it could not supply domestically. In particular, China's imports of fertilizer, sugar, and cotton rose sharply. China also imported 15 million metric tons of grain.

A sharp increase in exports—a result of incentives to state trading companies introduced in early 1988—was a mixed blessing. Rapid export growth worsened domestic shortages of energy and raw materials and bid up domestic prices. Because China's skewed domestic price structure severely underprices raw materials and energy, trading companies rushed to export these commodities when Beijing eased control over the foreign trade sector. Exports of pig iron, steel,

Figure 1
China: Portrait of an Overheated Economy, 1988



Source: Official Chinese statistics

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coal, nonferrous metals, raw silk, and cotton all jumped even though domestic factories were reporting shortages of the same goods. Trade corporations reaped large profits by buying these goods at low, state-set prices and exporting them at higher international prices.

Rapid export growth also widened regional income disparities, which have been a source of debate within the leadership. Coastal provinces, with relatively modern factories, a fairly skilled work force, and access to ports and rail lines that link China to the outside world, have provided more than 70 percent of China's exports in recent years. This has given them greater access to credit and foreign exchange, more rapid gains in income, and greater independence from Beijing than the inland provinces have enjoyed. The interior areas, unhappy about the growing regional income disparities last year, boosted interprovincial trade barriers to protect their supplies and prevent the wealthier coastal provinces from bidding up prices of their industrial supplies, coal, grain, and pork.

Economic Reforms Stall as Beijing Attempts To Reassert Control

Spurred by these mounting problems, Chinese leaders announced at a party plenum in September 1988 that they would postpone key market reforms for several years and implement an austerity program to cool the economy. In particular, Beijing shelved a plan to push ahead with price decontrol, currency devaluation, and reduced state intervention in raw materials distribution, which apparently was sponsored by former party chief Zhao Ziyang. Leaders were concerned because rumors of impending price reforms, proposed by Deng Xiaoping in May 1988, prompted bank runs and panic buying sprees in July and August 1988. Continuing bank runs could have caused serious dislocations; consumers' bank accounts total 380 billion yuan ($103 billion)—equivalent to 27 percent of GNP.

As part of its retrenchment plan, Beijing has issued a series of directives since September 1988 designed to slow capital construction, restrict spending, and control price hikes:

- Beijing announced it would cut state investment spending by 20 percent in 1989. The burden is to fall on nonproductive projects such as worker housing and recreational facilities.

- To discourage bank-financed investment outside the state plan, Beijing tightened credit ceilings for its domestic banks and raised interest rates on bank loans. Chinese authorities have also called for a halt in loans to private and rural enterprises.

- China's central bank hiked interest rates on household deposits, indexing those with maturities of three years or longer to the retail price index, and imposed limits on the amounts individuals could withdraw from savings accounts.

- Beijing reduced the number of government entities authorized to borrow funds abroad from 100 to only 10 to slow the flow of credit acquired through foreign channels.

- Beijing reimposed price controls for steel, copper, aluminum, and other production materials.

- The State Council recentralized control over the production and marketing of certain steel products and nonferrous metals. The central government also reestablished its monopoly over the distribution of fertilizer, pesticides, and plastic sheeting to control speculation in farm inputs.

- To stimulate lagging agricultural production, Beijing announced an increase in the state procurement prices paid to peasants for their grain, sugar, and oil-bearing crops. Beijing also hiked the state procurement price of coal.

Since September 1988, Beijing has also reasserted central control over foreign trade. To curb exports of scarce commodities, Beijing expanded the number of products subject to export licenses, quotas, and outright bans. It also tightened control over imports by restricting the number of corporations authorized to import several products, by banning purchases of selected consumer goods and industrial inputs, and by tightening control over the use of foreign exchange retained by exporters in Bank of China accounts. In addition, Beijing reduced the share of foreign exchange that China's five Special Economic Zones (SEZs) were permitted to retain from their exports.

Problems Persist in 1989

Chinese statistics for the first half of 1989 indicate that these efforts have been only partially effective. China's industrial growth rate fell by almost one-half to about 11 percent, but inflation continued at a more than 25-percent annual clip. Although Beijing was able to sharply slow growth in capital construction spending during early 1989, the impact seems to have hurt state enterprises more than collective or rural industries. According to Chinese statistics, rural enterprises grew three times faster than key state-dominated sectors such as energy during the first quarter. Thus, slower overall growth did not ease inflationary pressures.

Demand pressures have apparently also been sustained because of weaknesses in the enforcement of Beijing's retrenchment program. For example, Beijing apparently loosened credit restraints in March 1989 because of concern about a sharp decline in production of state-owned enterprises. Meanwhile, factories were circumventing the credit controls by drawing on the resources of widespread nongovernment financial institutions. Access to financing from Hong Kong enabled many enterprises, particularly in the southern

Government Intervention in China's Trade Sector

Chinese officials have acknowledged that Beijing plans no further progress on foreign trade reform for the next few years. Thus, extensive state controls will continue to guide China's trade. Beijing still restricts the number of entities that are authorized to conduct trade; export and import prices remain largely state-determined; and the government continues to provide financial support to unprofitable factories and trade corporations. Moreover, the value of China's nonconvertible currency is still fixed by central authorities.

Trade Subject to Plans. *Roughly 70 percent of China's trade—both exports and imports—remain subject to either "mandatory" plans set by Beijing or "guidance" plans negotiated by central and local officials.*

Restrictions on Authorized Traders. *Few factories have authority to sign trade contracts directly with foreign firms. Beijing prohibits private enterprises and foreign-invested ventures from signing trade contracts.*

Commodity-Specific Quotas and Bans. *Since November 1988, Beijing has banned imports of a variety of consumer goods, including liquor, sodas, and color televisions. Beijing has added several minerals, alloys, chemicals, and consumer goods production lines to the list of prohibited exports in 1989.*

Licenses. *Half China's trade is subject to import or export licenses. Trade reforms have generally shifted issuing authority from central to provincial levels without diminishing the share of trade covered by licenses.*

Export and Import Pricing. *Export prices on finished goods are generally set on the basis of international prices, rather than domestic costs of production. In a dozen product lines, cartel-like export associations regulate pricing to ensure that exporters do not cut prices to compete for foreign sales. Imports are generally sold in China's domestic market at state-set prices.*

Subsidies. *The State provides grants to state trade corporations that lose money on export or import transactions because of the gaps between China's domestic prices and prices in international markets. Export subsidies probably amounted to $6-8 billion in 1988, equivalent to up to 15 percent of China's export earnings.*

Foreign Exchange Controls. *Beijing sets the official exchange rate for China's nonconvertible currency and strictly controls the use of foreign exchange. Beijing also requires export corporations to turn over to higher authorities most of the foreign exchange they earn. Central or provincial authorities monitor closely how traders use the portion they are permitted to retain.*

provinces closest to the territory, to ensure they would have a steady flow of monetary resources despite Beijing's attempts to rein in credit.

China's trade balance continued to worsen early this year. Imports grew five times faster than exports in the first five months of 1989; China's trade deficit grew from less than $1 billion in the first five months of 1988 to nearly $5 billion as of May 1989, according to official Chinese Customs statistics. Purchases of production materials in short supply domestically—such as steel, synthetic fibers, and fertilizers—led the import surge. Meanwhile, exports apparently languished because of the slowdown in China's state-owned industrial sector.

Turmoil Worsens Economic Difficulties

The new leadership has endorsed a continuation of the austerity program, but the social and political turmoil that has gripped China since April will make it difficult for Beijing to solve its pressing economic problems. First, the preoccupation of China's leaders with consolidating power, ridding the bureaucracy of Zhao Ziyang's supporters, strengthening party control, and restoring ideological orthodoxy will prevent them from formulating new solutions to China's economic problems.

Second, pressures to increase government expenditures and expand the money supply have probably grown because of the social unrest. Beijing may attempt to increase income subsidies and loans to state enterprises enough to ensure that wages of most urban workers keep pace with inflation.

Beijing may also worry that peasants might become restive because they are being pressed to grow more grain but are having increasing difficulty obtaining inputs and payment from a financially strapped government. In a speech in June, Li Peng called for greater efforts to solve rural credit shortages that have forced state procurement agents to pay peasants with IOUs instead of cash. Beijing began issuing IOUs in the fall of 1988 when retrenchment-related credit restrictions and bank runs caused a shortage of funds in rural banks. Chinese press reports have claimed that an additional 10 billion yuan will have to be provided to local grain procurement stations to solve the problem. Officials fear that, if peasants are forced to take IOUs again, they might simply refuse to hand their grain and other commodities over to the state. Beijing apparently hopes to tap local funds for most of the money, but these are funds that might otherwise have gone for more profitable undertakings like investment in rural industry. More likely, however, given Beijing's difficulty implementing central directives at the local level, the funds will come from short-term loans from the central bank, which will add to inflation. Chinese press reports indicate that, as of mid-June, the central bank had already made more than 4 billion yuan available for this purpose.

Pressure for increased government spending may also come from China's military. After a decade of declining influence, China's military leaders probably will play a larger role in politics and in the economy in return for their support for the crackdown in Beijing. Military leaders probably will petition civilian authorities to reverse the decadelong decline in the share of the budget going to defense.

Local Resistance Remains

Beijing's preoccupation with social and political issues will accelerate the trend toward economic autarky at the local level in China, and increased provincial resistance to Beijing's directives will undermine the effectiveness of efforts to slow the economy. Local governments will probably strongly resist implementing austerity measures in their own areas, for example, by resuming some of the construction projects that central authorities cancelled early this year. This resistance will be especially strong in wealthy southern provinces, where reform and an open door to Western business have yielded significant economic benefits. Local governments may also heighten existing barriers to trade with other parts of China to protect their own industries, making it difficult for Beijing to implement economic policies consistently when authorities turn their attention back to economic issues.

Other Pressures To Relax Austerity

The reluctance of foreign businessmen and governments to proceed with investment, trade, and technological exchanges following the crackdown in Beijing has also weakened the authorities' ability to implement the austerity program. For example, since the start of the retrenchment program, foreign investors have complained that credit shortages have eroded their profit margins by cutting their sales within China. Beijing may now be forced to expand credit to foreign-funded ventures as part of its effort to convince foreign traders and investors that the business environment is stable and that they can make money in China.

For similar reasons, Beijing may have to back investment commitments made before the crackdown that it might otherwise have postponed. China's southern coastal provinces apparently signed many contracts in the first few months of 1989, hoping to get funds either from Hong Kong sources or from the central government for the Chinese portion of the projects before the retrenchment program really took hold. Beijing will now have to provide the money itself or ease controls on foreign borrowing to keep foreign investment levels up to lend credence to its claims that business is back to normal.

Near-Term Economic Problems Mount

Competing pressures to increase spending will probably prevent the retrenchment program from bringing inflation under control. In urban areas, inflation will probably remain above 20 percent through the end of 1990; nationwide, inflation is also likely to remain in double digits for at least the next 18 months. Blanket controls on prices could reduce the inflation rate, but would fail to reduce imbalances between demand and supply and would lead to widespread reimposition of rationing. Persistent inflation will fuel urban unrest by eroding the living standards of a large segment of China's workers. Chinese statistics for the first half of 1989 indicate that the real incomes of state workers declined despite a nearly 19-percent increase in nominal wages and subsidies. Beijing's recent decision to force factory workers to purchase government bonds has heightened their resentment; many believe they are bearing the brunt of the austerity program.

The retrenchment policies and midyear work disruptions will slow the overheated economy somewhat, but will enlarge China's pool of unemployed. Senior Chinese officials have admitted that the slower economy will be able to absorb only half of the 10 million workers entering the urban labor force this year.

Increased spending will probably cause China's government budget deficit to grow this year. Beijing will probably have to bail out growing numbers of unprofitable state enterprises as wider price controls on finished goods prevent factory managers from recouping losses caused by work slowdowns, energy and transportation disruptions, and higher wages and bonuses for workers. Expenditures on consumer subsidies, infrastructure development, and—most likely—defense will also grow. Meanwhile, slower overall growth and declining enterprise profits will cause government revenues to stagnate.

Damage to China's Foreign Economic Relations

The retrenchment program had begun to take its toll on exports and foreign investment even before the demonstrations; both had been projected to slow in 1989 and 1990. The downturn is now likely to be much sharper because of the damage to China's economic relations with foreign businesses caused by the crackdown. Because Beijing started 1989 with about $17 billion in foreign exchange reserves, it can probably ride out the downturn this year, but the problems will increasingly take a toll in the early 1990s.

Tourism Will Plummet

Tourism will probably remain depressed through at least the end of the year and possibly into the early 1990s. Tourism last year earned Beijing $2.2 billion in foreign exchange and had been expected to generate about $2.5 billion in 1989. Despite robust tourist travel in the first half of this year, China will probably take in only $1.5 billion from tourism in 1989.

New Foreign Investment Contracts Will Slow

Many investors seeking low-cost Asian production sites are now looking to other countries, such as Thailand, the Philippines, and Malaysia. Moreover, investors already operating in China have, by and large, shelved expansion plans indefinitely. Hong Kong businessmen, who have provided two-thirds of China's foreign investment, will probably react especially sharply; many of the territory's wealthiest magnates are scrambling to extricate themselves from existing mainland projects while also intensifying efforts to get out of projects in Hong Kong before the territory reverts to Beijing's control in 1997. Those investors that proceed with China projects will probably focus on short-term investments that involve small capital commitments and little investment in machinery and infrastructure.

For all of 1989, new investment contracts will probably fall short of the $5.2 billion in new contracts signed last year (see table 1). Before the crackdown, Beijing might have expected a record $8 billion in new contract signings on the basis of the surge in new contract signings in the first five months of 1989.

Table 1
New Foreign Investment Contracts, 1988

	Number of Projects	Value (*million US $*)
Total	**5,890**	**5,180**
Hong Kong	4,562	3,400
United States	269	370
Japan	235	275
Netherlands	5	150
West Germany	23	47
United Kingdom	21	41
France	12	23
Other	763	874

Source: Official Chinese statistics.

Paid-in investment, which reflects contracts signed in 1988 and in early 1989, may exceed 1988's level of $2.6 billion.

Foreign investment has a fairly limited impact on the country's economic growth in the short run; annual inflows are equivalent to roughly 2 percent of domestic investment, and foreign-invested projects last year generated only 2 percent of China's industrial output and 5 percent of its export earnings. But foreign investment has brought in crucial technical and managerial expertise and helped to improve production efficiency and quality control, especially in coastal provinces, which have drawn 90 percent of China's foreign investment.

Low-Interest Foreign Loans Have Been Postponed Indefinitely

At the request of many of the countries that donate funds to international financial institutions like the World Bank and the Asian Development Bank, billions of dollars worth of concessional financing has been placed on hold. In addition, Japan and most West European countries have delayed promised low-interest development loans to China pending the restoration of social and economic stability. Most of these loans would have gone to the energy, transportation, and telecommunications sectors. Rates on foreign commercial loans will probably be raised as

Investors Reassess the Risks and Rewards of China Projects

Beijing is attempting to salvage its economic relations with the West in the aftermath of the crackdown. Li Peng has ordered China's "foreign investment leading group" to assure foreign investors that China remains open to the outside world. Coastal provinces and cities in southern China that have come to rely on the infusion of foreign funds, technology, and managerial and marketing expertise have also stepped up efforts to lure investors back. Along with the inducements, Beijing has made veiled threats that China will penalize foreign businessmen that pull out of existing ventures or halt negotiations on future projects.

Some foreign businessmen will no doubt be attracted by the lower taxes or greater access to China's domestic market that Beijing may offer as sweeteners. But many foreign firms had been operating on thin profit margins—and even accepting losses—in the hope that continued evolution of China's economy to a legally based, market-oriented system would ensure large profits in the long run. Beijing's crackdown and subsequent show trials of arrested workers and students, however, have probably convinced many foreign businessmen that China's political system is not stable enough to allow any leaders to implement economic reforms consistently or to strengthen legal processes.

These doubts have probably been reinforced by the replacement of Zhao Ziyang and many of his allies in the leadership with conservative economic planners. Uncertainty about the stability of the current leadership coalition after Deng Xiaoping passes from the scene probably also adds to caution by foreign investors. In addition, although profitable niches will remain, some potential investors may be deterred by a pragmatic assessment of their ability to earn profits, given China's economic problems and the leadership's public commitment to austerity.

Near-Term Outlook for China's Economic Reform Program

Reform	Major Purpose	Outlook
Price	*To make the price structure more accurately reflect relative scarcities by allowing selected prices to move to market levels.*	*On hold as Beijing tries to control inflation.*
Wage	*To link productivity and wages more closely.*	*Likely to continue as Beijing seeks to maintain output, but may be watered down by the need to continue subsidies and worker bonuses regardless of productivity.*
Enterprise		
Bankruptcy	*To force management to employ resources more efficiently.*	*Not likely to rigorously enforce bankruptcy law because increased business failures would add unemployed workers to the already volatile urban population.*
Stock ownership	*To cut firms free from central funding by allowing up to 50 percent of stock to be owned privately.*	*Backed mainly by Zhao, likely to remain on hold because conservatives have ideological objections to private ownership of large enterprises.*
Contract system	*To increase managers' responsibility for profits and losses by requiring them to adhere to financial quotas negotiated between factories and their supervisory bureaus.*	*Likely to be retained because it ensures the central control favored by conservatives; may be adjusted to reduce focus on negotiated quotas, faulted for favoring certain enterprises.*
Foreign trade	*To encourage exports by allowing exporters to retain a share of their foreign exchange earnings; preferential policies for coastal export-producing regions.*	*Recentralized state control over key exports and imports in late 1988 and curtailed regional incentives. Could place more products under central control, limit the number of trade corporations.*
Agriculture	*To encourage diversified farm output by offering farmers contracts for staples like grain in exchange for subsidized inputs, or the option of growing crops not under state control.*	*Beijing will probably try to steer agricultural production back to basics and limit expansion of nonstaple farm production.*
Rural enterprise	*To invigorate rural economy by absorbing excess farm labor, producing consumer goods, and generating tax revenues for local government projects.*	*Beijing has already begun squeezing this profitable sector's access to credit and hiking its taxes and could also opt to channel raw materials to needy state-run firms instead of rural enterprises.*

banks reevaluate China's creditworthiness given the expected drop in foreign currency inflows from tourism, foreign investment, and exports.

Export Growth May Slacken

Recently released Chinese statistics suggest that China lost up to $100 million in export revenues daily during the height of the crisis. Lost earnings probably amounted to $1 billion in the first two weeks of June, and exports for the latter half of June were slightly lower than usual, suggesting that these losses may not be made up even though rail lines, ports, and Chinese trade offices are back to normal operations. Foreign purchasers of Chinese manufactured goods may wonder if additional worker strikes or slowdowns will prevent China from meeting its commitments in the future; many are reported to be investigating other sources for the textiles, toys, and other labor-intensive light industrial goods they buy from China. Shortages of credit and raw materials in China—as well as rising input costs—will also slow export growth to single digits for the next few years. Exports had been growing at nearly a 20-percent annual clip for the last four years.

More Controls on Imports Are Likely

Beijing's concern that China's foreign exchange reserves may drop quickly as a result of the deteriorating trade balance and sharp declines in tourism and foreign investment inflows could lead to additional controls on the use of foreign exchange for imports. Although grain and agricultural inputs will very likely remain exempt, Beijing will almost certainly tighten controls over items like consumer goods that are not in the annual import plan. Beijing might also curtail purchases of industrial equipment and scarce raw materials to conserve foreign exchange, even though reduced purchases of these items would probably slow industrial and export growth in the early 1990s. If China experiences a foreign exchange crunch, it may increase barter trade with the Soviet Union and Eastern Europe. In particular, Beijing might increase purchases of raw materials it imports from the Soviet Union, like fertilizer, iron and steel, and nonferrous metals—some of which it now uses hard currency to purchase from Western suppliers. It might also increase purchases of Soviet heavy industrial and power-generating equipment, which some Chinese leaders consider more suited to Chinese conditions than that available from Western suppliers.

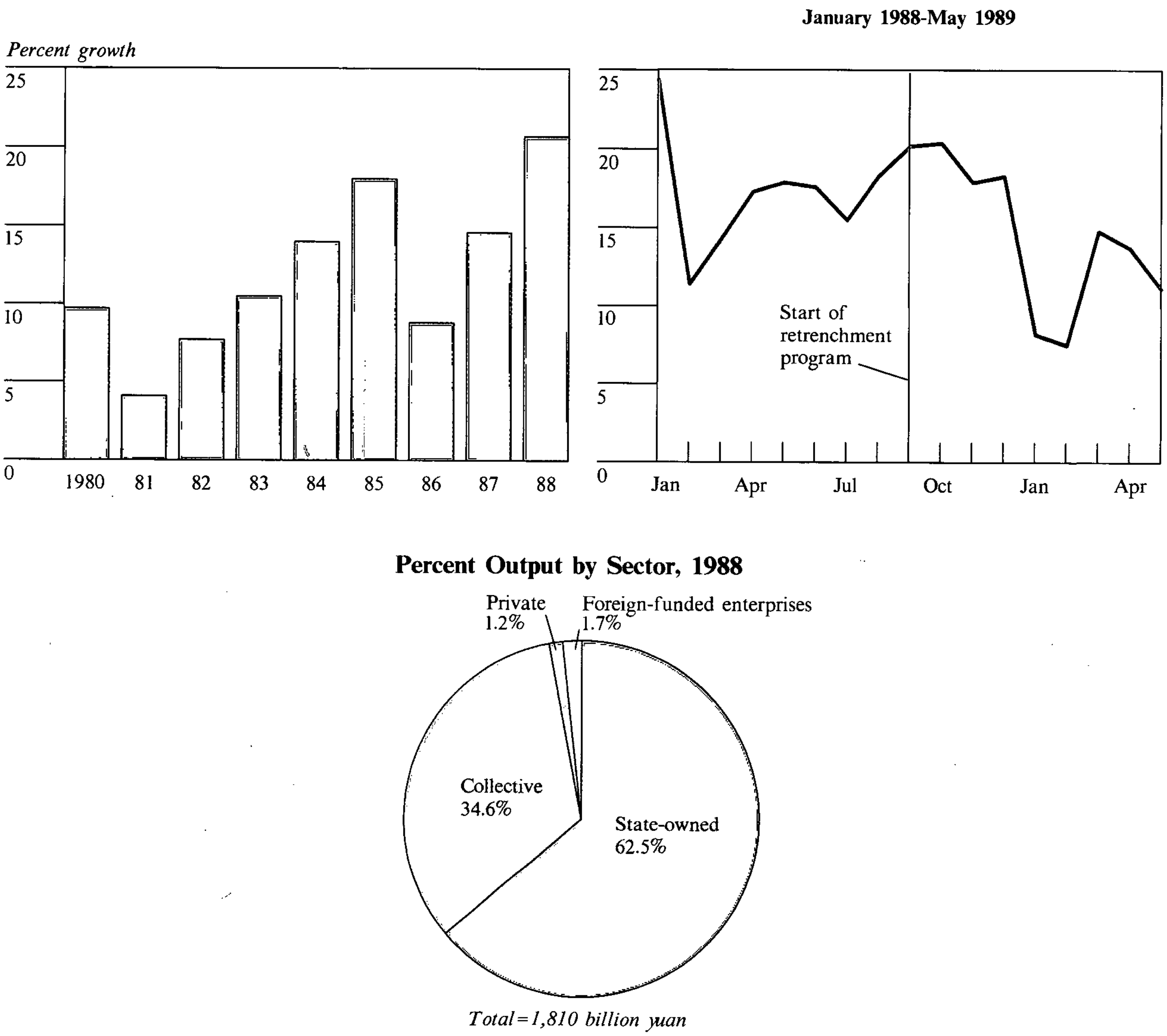
Outlook for Reform

In speeches since the crackdown Deng Xiaoping has reiterated his commitment to pursue economic reform. The main elements of Beijing's market-oriented reform program, however, have been stalled for almost a year. Such key reforms as price decontrol and bankruptcy are likely to be postponed indefinitely because Beijing does not want to add to its problems by implementing measures that would raise prices or swell the ranks of the urban unemployed. Experiments with stock ownership in state enterprises—implemented by Zhao Ziyang over the strong ideological objections of hardline leaders—are certain to fall by the wayside.

Under the guise of austerity, the hardliners may try to chip away at market reforms, clamping down on previously decontrolled prices and exerting closer central control over some collective and private enterprises that compete with state factories for raw materials. They may even restrict the ability of state enterprises to sell overquota production at market prices. Hardliners, however, can turn back the clock only so far. Local officials would strongly resist efforts by Beijing to reclaim financial and planning authority. In addition, efforts to roll back reform would be strongly resisted by Deng Xiaoping, who views rapid reform-driven growth in the last decade as one of his major accomplishments.

Without further reform, however, China will be unable to alleviate the imbalances in its economy. Without price reform, for example, Beijing will continue to have problems boosting grain production, encouraging development of energy and raw material resources, and stimulating exports of labor-intensive manufactured goods rather than scarce resources. Without additional enterprise reforms, industrial efficiency and labor productivity will lag, and Beijing will experience difficulty encouraging enterprises to make responsible decisions regarding capital investments and salary and bonus increases. Continuing economic problems will stoke social and political unrest in the 1990s.

Figure 2
Chinese Industrial Output



Source: Official Chinese statistics

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Appendix A

Economic Performance in 1988 and 1989 by Sector

Industrial Performance

Industrial production rose at a breakneck pace of almost 21 percent in 1988 (see figure 2). State-sector industrial production rose about 13 percent; the collective and private sectors grew 29 percent and 46 percent, respectively. Foreign-funded enterprises doubled their industrial output.

This rapid growth intensified China's energy deficit. Overall energy production climbed about 4 percent in 1988. Although production of electric power grew 9 percent last year, electric power shortages idled factories for several days each week. Output of coal and crude oil increased only 4.5 percent and 2 percent, respectively. Transportation bottlenecks compounded the energy shortage by delaying deliveries of coal—which accounts for more than 70 percent of China's energy supply—from mines in the northeast to power plants in southern and eastern China. Rapid growth also intensified shortages of key raw materials. Steel production, for example, increased only 5 percent in 1988.

Although industrial output grew at an 11-percent annual rate through June—about half last year's rate—sharp increases in input prices at the end of 1988 caused the profits earned by China's state-run factories to decline 12 percent. Moreover, imbalances between overall industrial growth and the production of energy and raw materials persisted. Energy production grew at a 5-percent annual rate in the first four months of 1989, and output of raw materials actually fell.

China's Energy Minister called this year for easing the energy crunch by increasing state investment in hydroelectric and nuclear power and in crude oil and natural gas extraction. Even if China's financially strapped government can come up with the funds for these projects, however, it would take years for increased energy production to come on line.

Agriculture and the Rural Economy

The value of China's agricultural output increased about 3 percent in real terms in 1988. Most of the increase was accounted for by expansion of sideline industries, like poultry and fishery operations, and a sharp increase in the production of cash crops such as tobacco and silk. Grain production fell 2 percent last year to 394 million metric tons, 16 million short of target (see figure 3). As a result, China imported 15 million metric tons of grain—primarily from Canada and the United States (see figure 4).

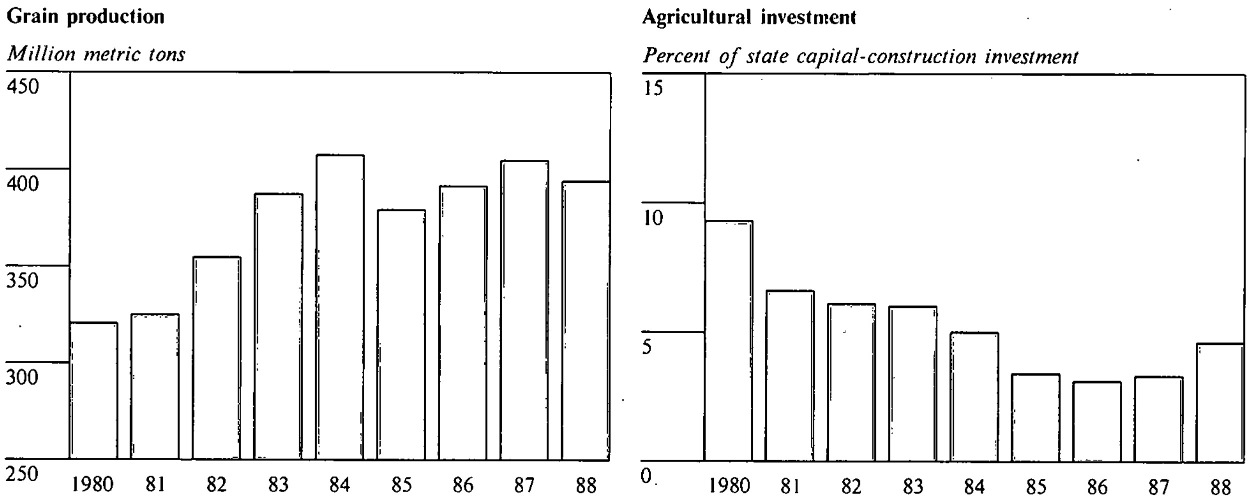
Rural industry and commerce are among the most dynamic segments of the Chinese economy and since 1987 have accounted for more than half the value of rural output (see figure 5). They currently employ more than 85 million people, about 15 percent of China's labor force.

After last year's fourth consecutive disappointing harvest, a broad spectrum of China's leadership agreed that, without redressing long-term problems, the stagnant farm sector could prove a major stumblingblock to overall economic development. Premier Li Peng called agriculture the "weak link" of China's economy in his keynote address to the National People's Congress this spring, underscoring agriculture's fall from grace as a symbol of reform success. To address the problem, this year Beijing has:

- Raised producer prices for government-contracted grain, cotton, sugar, and oil-bearing crops and agreed to purchase over-quota commodities at market, rather than lower, state-set prices.

- Recentralized the distribution of fertilizer, pesticides, and plastic sheeting used as mulch and agreed to supply more of these inputs at favorable prices to peasants who grow grain.

Figure 3
Chinese Agricultural Production, 1980-88



Source: Official Chinese statistics

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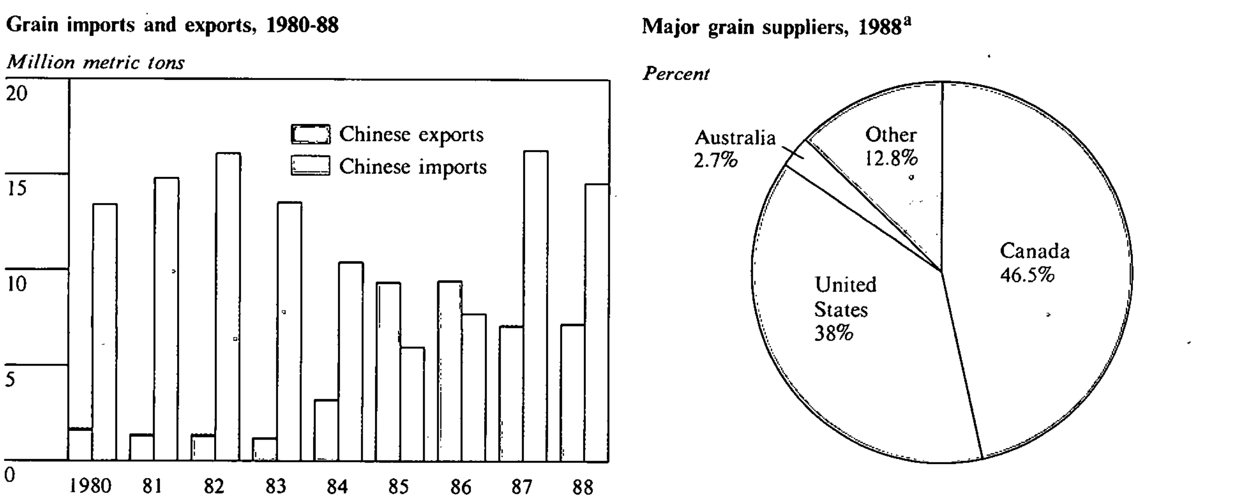
Figure 4
Chinese Grain Trade, 1980-88



[a] Calculated by value of exports.
Source: Chinese Customs statistics and partner-country-trade statistics.

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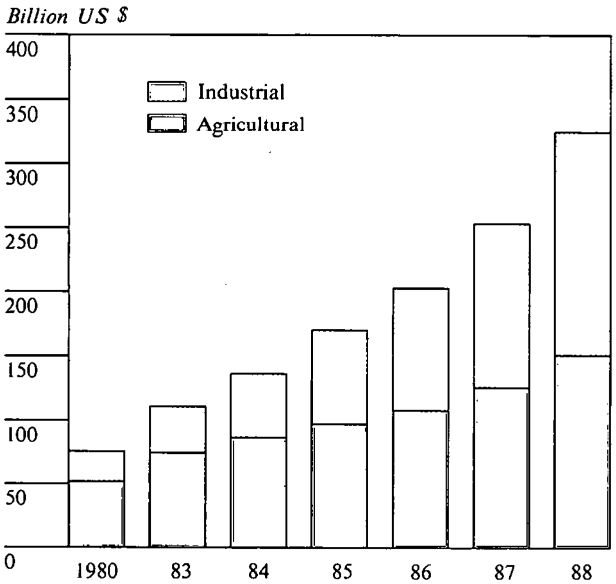
Figure 5
Gross Value of Rural Output, 1980-88[a]



[a] Data not available for 1981 and 1982.
Source: Official Chinese statistics

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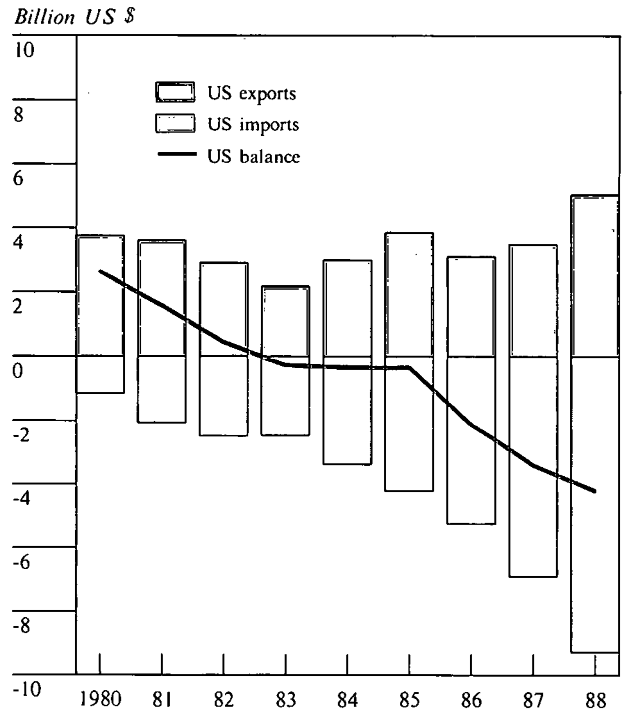
Figure 6
US-China Trade, 1980-88



Source: US Commerce Department

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- Decided to increase government investment in agriculture by 14 percent. It will raise funds to cover increased investment by setting aside a portion of foreign loans and by increasing taxes on rural enterprises and on production of nonstaples.

Beijing also will continue to tinker with reform experiments in a few cities. For example, one Chinese city reportedly will open a wholesale grain market to establish an institutional framework for domestic grain trade. In general, however, China's new conservative leadership will rely on administrative controls rather than strengthen the role of markets in guiding agricultural policy.

US-China Trade

In 1988 China was the United States' 13th-largest trading partner. The United States, in turn, was China's third-largest trading partner, ranking behind Hong Kong and Japan and ahead of West Germany and the Soviet Union. According to US Commerce Department statistics, US exports grew a robust 44 percent over 1987 levels, and for the first time exceeded $5 billion. Imports from China increased by more than one third to $9.3 billion, and the US deficit widened almost a fourth to $4.2 billion (see figure 6).

Table 2
Selected US Exports to China, 1988

	Value (*million US $*)	Share of Total (*percent*)	Growth Over 1987 (*percent*)
Total US Exports	**5,032.9**	**100**	**44**
Of which:			
Grain	698.9	14	199
Plastics, resins	595.9	12	134
Wood products	447.1	9	167
Fertilizers	378.7	8	40
Aircraft	341.1	7	−32
Specialized machinery	334.0	7	42
Organic chemicals	256.7	5	71
Scientific equipment	200.1	4	20
ADP equipment	200.1	4	6
General industrial machinery	171.6	3	−3

Source: US Commerce Department. Exports calculated freight on board (f.o.b.).

Table 3
Selected US Imports From China, 1988

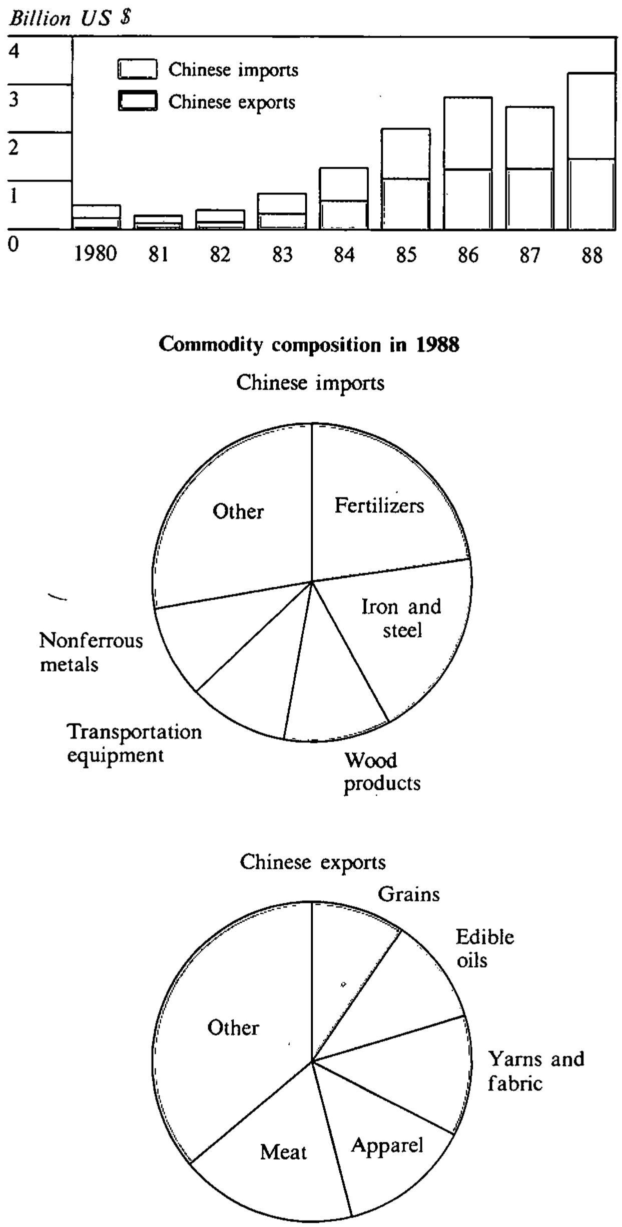
	Value (*million US $*)	Share of Total (*percent*)	Growth Over 1987 (*percent*)
Total US Imports	**9,269.8**	**100**	**34**
Of which:			
Clothing	2,212.6	24	1
Toys, sporting goods	1,838.4	20	42
Yarn, fabrics	608.0	7	9
Telecommunications equipment	528.6	6	112
Petroleum	496.7	5	−6
Household electrical appliances	465.6	5	198
Travel goods, handbags	461.9	5	45
Shellfish, seafood	331.1	4	131
Metal manufactures	266.0	3	66

Source: US Commerce Department. Imports calculated free alongside ship (f.a.s.).

US exports to China last year benefited from strong Chinese demand for agricultural products and inputs (see table 2). US exports of grain were triple the 1987 level. Plastic sheeting, fertilizers, and pesticides also posted healthy gains. US exports to China will probably continue to show fairly strong growth in 1989; even if Chinese purchases of industrial machinery and timber decline as a result of the curbs imposed on capital construction, demand for grain and agricultural inputs is likely to remain strong. In the first five months of 1989, for example, US exports to China increased 30 percent over the same period in 1988; sales of grain, raw cotton, aircraft, and fertilizers showed especially strong growth.

Last year manufactured goods accounted for 85 percent of US imports from China. Toys, sporting goods, radios, small electrical appliances, and travel goods have grown especially rapidly (see table 3). Textiles and apparel accounted for one third of China's US sales, but growth slowed to single digits last year, largely because of disruptions resulting from the decentralization of China's trade sector. Newly empowered exporters in China's interior rushed to earn foreign exchange by selling raw cotton, silk, and wool—thereby curtailing supplies available to Chinese garment manufacturers. At the same time, cutthroat pricing tactics by Chinese exporters meant that increases in the volume of exports were not always matched by increases in foreign exchange earnings. US Commerce Department statistics through May 1989 indicate that recentralization of trade has enabled China to boost growth in its earnings from textiles and apparel sales to the United States back to double digits; the most rapidly growing export products remain household electrical appliances, radios, and footwear. Consequently, the US trade deficit is likely to grow again this year, and will probably exceed $5 billion by yearend.

Figure 7
Sino-Soviet Trade



Source: Chinese Customs statistics

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Sino-Soviet Economic Relations

Sino-Soviet trade grew 27 percent last year to almost $3.3 billion (see figure 7). Chinese statistics for the first half of 1989 indicate even stronger growth, with Chinese imports surging 63 percent and exports up 12 percent over a year earlier. Trade along the Sino-Soviet border was the most dynamic aspect of bilateral trade last year, increasing exponentially to account for nearly 10 percent of total Sino-Soviet trade. Border trade will continue to grow in 1989. China's border provinces have enthusiastically embraced it because they lack easy access to other markets. Moreover, it frees Beijing from having to subsidize purchases of Soviet goods to induce Chinese enterprises to accept them.

The scope of Sino-Soviet economic relations broadened last year to include some new forms of cooperation:

- Chinese laborers began working on projects in the Soviet Union under compensatory-trade arrangements that generally exchange Chinese labor services for a percentage of the goods produced. Over 8,000 Chinese workers are already in the Soviet Union with at least 5,000 more to follow this year under labor agreements signed in 1988.

- Joint ventures—particularly those combining Soviet raw materials and equipment with Chinese labor—are actively being pursued; the first are likely to begin operations this year.

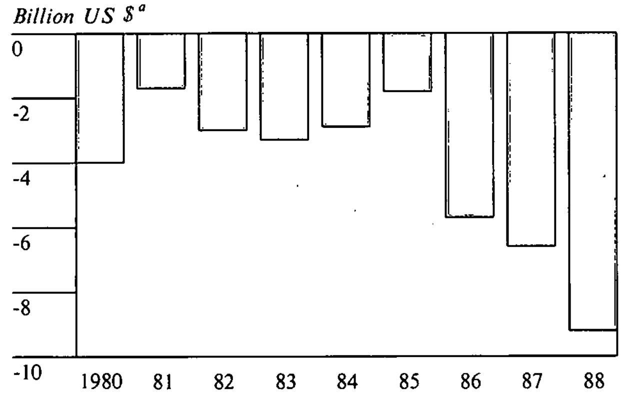
- Both sides agreed to swap branch offices of their foreign exchange banks, and Moscow provided more than $400 million in trade-related credits in the form of low-interest government loans payable in goods and services. For the first time, the Bank of China participated in a syndicated loan—valued at $50 million—for a Soviet bank.

Moscow and Beijing are unlikely to be successful in expanding the range of economic relations significantly beyond their current levels despite the boost provided to bilateral relations by Gorbachev's visit to China this spring. Beijing will probably continue to favor Western technology, and Chinese trading companies will prefer to sell their output in the West for hard currency. Chinese imports of goods such as timber and fertilizer, where the quality of the Soviet commodity is comparable to that available elsewhere, will probably grow this year as Beijing turns to barter to conserve foreign exchange.

Although labor exports will continue to grow over the next year, the Soviet Union probably is reluctant to have too many Chinese laborers within its borders. Cooperative projects, particularly in the energy and heavy industry sectors, hold the greatest potential for expanded economic relations, especially if foreign investment from Hong Kong and the West slows, as anticipated.

Figure 8
China's Budget Deficit, 1980-88

[redacted]



[a] 1 dollar=3.72 yuan
Source: CIA estimates based on Chinese statistics

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The State Budget and Spending Priorities

China's government budget deficit grew almost 50 percent in 1988 to reach $9.2 billion (see figure 8). Rapid growth in subsidies was largely responsible for the sharp increase. Indeed, rising raw materials prices caused losses of state enterprises to climb almost 27 percent last year.

Beijing financed the deficit by issuing domestic bonds, taking on greater foreign debt, and printing money. In 1988 the government covered about 38 percent of its deficit by selling treasury bonds domestically and financed an equal amount through foreign loans. It made up the rest with central bank overdrafts—the equivalent of printing money.

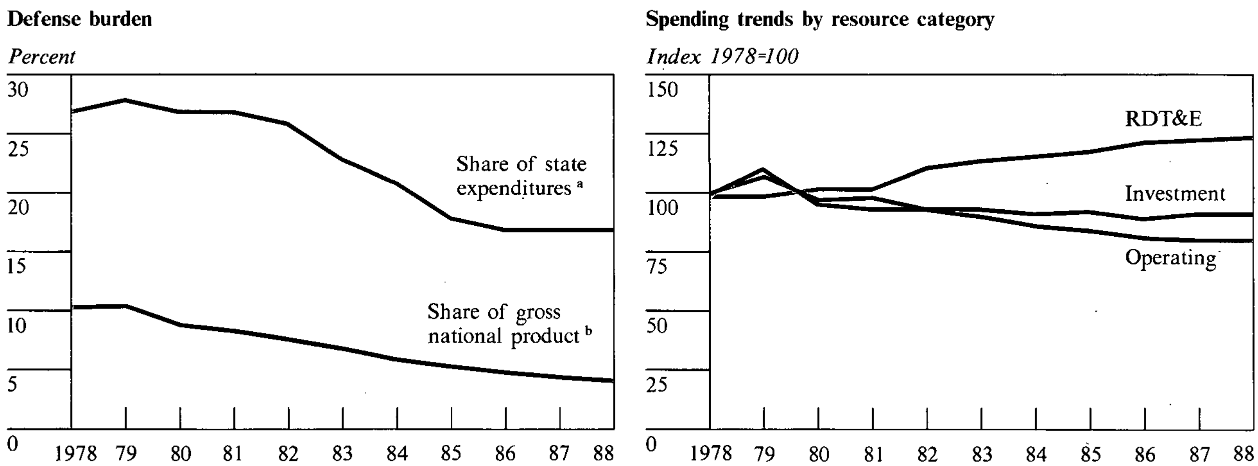
Although China's deficit is low by international standards—it equaled about 2.5 percent of GNP in 1988—leaders are concerned about its rapid rise because it is adding to inflationary pressures and because it is increasing China's foreign indebtedness. Moreover, it is a political problem for reformers; many of China's conservative leaders view any level of government deficit as an indication of economic mismanagement and could use it as one additional argument for holding off on reforms.

Beijing is trying to solve its deficit problem by increasing tax rates, widening its tax base, and improving collection efforts. As the austerity drive slows the economy, however, growth in tax revenues is likely to slow also. Meanwhile, since inflation has not yet abated, budget subsidies will continue to skyrocket. Thus, China's deficit this year will grow, probably exceeding $10 billion.

Defense Spending

China releases statistics on national defense spending as a line item in the annual state budget but provides neither a definition of the categories of expenditure included in the figure nor a breakdown of the total. Our estimates of Chinese defense expenditures cover spending for investment (primarily weapon procurement); operating expenses (including maintenance and personnel costs); and research, development, testing, and evaluation (RDT&E). Using a building-block approach for valuing the costs of these various components, we estimate that China's total defense expenditures for 1988 were roughly 45 billion yuan, more than twice the announced figure. At current exchange rates, this is equivalent to $12 billion.

Figure 9
Estimated Chinese Defense Expenditures, 1978-88



[a] Computed using CIA estimates for budget expenditures.
[b] Computed using Chinese statistics valued in yuan.

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Despite the difference in absolute values, China's announced figures and the CIA estimates both show declining trends in the defense sector's share of China's budget as well as in the size of the defense budget relative to GNP (see figure 9). CIA estimates indicate that defense expenditures accounted for about one-fourth of China's total budget in 1978, but less than one-fifth of the budget in 1988. Moreover, we estimate China's defense spending dropped from 10 percent of GNP in 1978 to only 4 percent in 1988—somewhat less than the 6 percent for the United States and significantly less than the 15 to 17 percent for the Soviet Union.

China has cut military spending by slashing personnel costs. Beijing has reduced its armed forces by about 3 million men since 1978, with most of the cuts coming from its ground forces. We believe China's military operating budget—nearly half of which goes for salaries—has declined by about one-fifth since 1978. Beijing has nearly completed its force reduction, but we believe that it may take several more years before demobilized men find civilian jobs and are moved from military posts. Expenditures on weapons procurement also declined about 10 percent in the last decade because Beijing has postponed major purchases until more technologically advanced weapons systems are available. We estimate that RDT&E expenditures have increased about 25 percent since 1978, although this category continues to account for only about one-eighth of China's defense spending.

Appendix B

How Reliable are Chinese Statistics?

Official Chinese statistics often provide useful indicators of the direction and magnitude of economic growth even though collection techniques are crude and local leaders sometimes deliberately fudge data. Although local officials may be more hesitant to report unfavorable economic information in the wake of recent social unrest in China, during the decade of reform, Beijing has vastly improved the quality of its data by introducing more sophisticated sampling and estimative techniques. Moreover, the scale of its effort has grown: China's State Statistical Bureau (SSB) currently employs more than 1 million full- or part-time workers.

The reliability of Chinese statistics varies according to the category of data. Some data series—such as unemployment—are so tainted that they are virtually unusable. In rural areas, there is a tendency to count all adults of working age as employed, a remnant of past practices of classifying all adults as working members of the commune. But rural reforms over the last decade have moved as many as 100 million peasants from farm work to other occupations, and Chinese statistics may not accurately tally the number gainfully employed in small rural factories and service trades, nor account for China's large "floating population" of peasants who have been unable to find work, many of whom have migrated to urban areas. Moreover, the SSB does not account for the fact that many Chinese are employed, but do little or no work. By one estimate, one-third of state-sector employees do not contribute to production. Consequently, official statistics exaggerate the size of China's work force, understate its unemployment problem, and make it impossible to assemble labor force statistics that are reliable in the Western sense.

Another problem with Chinese statistics is that for many years Beijing collected data within the context of socialist doctrine, which dictates that productive labor is transformed only into material goods. Consequently, statisticians did not report adequately on nonmaterial sectors such as education, passenger transport, public health, banking, and government. Although scholars have since filled these data gaps, problems remain regarding the completeness of figures on nonmaterial services where reporting systems are still relatively underdeveloped. These sectors compose a small portion of GNP, but they are the fastest growing sectors of China's economy and their mismeasurement could become a problem in the future.

Broad measures of macroeconomic performance such as total social product and national income are useful indicators of economic change, although some components are suspect. For example, many rural regions do not distinguish between real and nominal values of output, which inflates growth rates. Beijing also calculates constant price indexes in terms of a 1952 price base, which produces higher growth rates than would result if researchers used more recent base years that more accurately capture China's current economic structure. Nonetheless, these forces tend to act on the data in a uniform manner so that the general series provides a suitable gauge of the level of general economic activity.

Beijing's inflation measures are also flawed, but useful, indicators of the domestic economy. China's price indexes may underestimate the impact of inflation, which, according to official estimates, vaulted to almost 20 percent last year. China's two most frequently cited price indexes are the general retail price index and the urban consumer price index. The former index is based on data from 12,380 shops and markets in urban and rural areas, and the SSB derives weights for this index from surveys of urban and rural household incomes and expenditures. Researchers separately calculate the urban consumer price index, which includes the costs of urban services. Although the SSB estimates these measures of inflation using internationally accepted sample survey techniques, we believe the indexes may understate inflation for two reasons. First, numerous regions obtain their price data from statistical reports submitted by shop owners who, because they face pressure from Beijing if their prices rise too sharply, may underreport their price increases. Second, the market basket the SSB uses to represent consumer buying patterns changes very slowly and is too heavily weighted with state-controlled goods. As Beijing has liberalized the economy, consumers have bought an increasing share of their goods on free markets at prices that exceed state levels. We report Chinese estimates of inflation, however, because they provide good qualitative indicators of price trends. Official statistics, for example, indicate that the inflation rate nearly tripled in 1988.

In some instances, we have sought to improve on official figures with our own estimates. For example, we are developing an estimate of China's gross national product (GNP) to correct some of the distortions inherent in China's official GNP numbers. Chinese GNP figures may not precisely gauge all sectors of China's economy; state controls, for example, skew relative prices and prevent the price structure from reflecting underlying market costs. The methodology we employ estimates GNP on the basis of an input/output model of the Chinese economy. The model is composed of 21 sectors, which are aggregated into three main sectors—agriculture, manufacturing, and services. The methodology generates total output estimates for each sector priced according to Chinese currency, transforms them into US dollar amounts by means of sector-specific dollar/yuan price ratios, then sums these data to obtain an estimate of Chinese GNP in US dollars.

We have estimated the cost of Beijing's national defense effort by a comparable process. We break the defense program down into its fundamental elements, calculate the cost of each part, then aggregate the individual costs. We begin by identifying the activities and physical components that constitute China's defense program for a given year and group them according to investment, operations, and research and development. Then we compare each activity or physical component with its most similar US counterpart to obtain an estimate in US dollars. This estimate reflects US production technology, prices, and profit margins, but incorporates the characteristics of the Chinese equipment. We take into account differences between US and Chinese production technology by considering different wage rates and prices of input materials. To create a cost estimate in yuan, we convert the dollar cost estimates using a series of conversion factors developed by comparing Chinese and US prices.

We also adjust the data China's Finance Ministry releases on the state budget deficit to bring it more in line with Western accounting practices. Beijing's methodology, which counts foreign borrowing and domestic sales of Chinese treasury bonds as "revenue" items, tends to understate the central government's debt obligations. Correcting the problem provides a more accurate measure of the budget's financial burden. For example, the Chinese calculated their deficit in 1988 at $2.2 billion, less than one-quarter of our estimate of $9.2 billion.

Notwithstanding the potential problems with Chinese data, we frequently report official statistics. Chinese leaders probably base decisions on the official data that is released publicly. Although leaders undoubtedly receive confidential reports on economic performance, on the whole, the government probably does not have a separate data set that is markedly more accurate than the information released by the SSB.